MOVE TO THE MIDDLE

BOOST THE EFFICIENCY OF YOUR MULTIFAMILY PORTFOLIO

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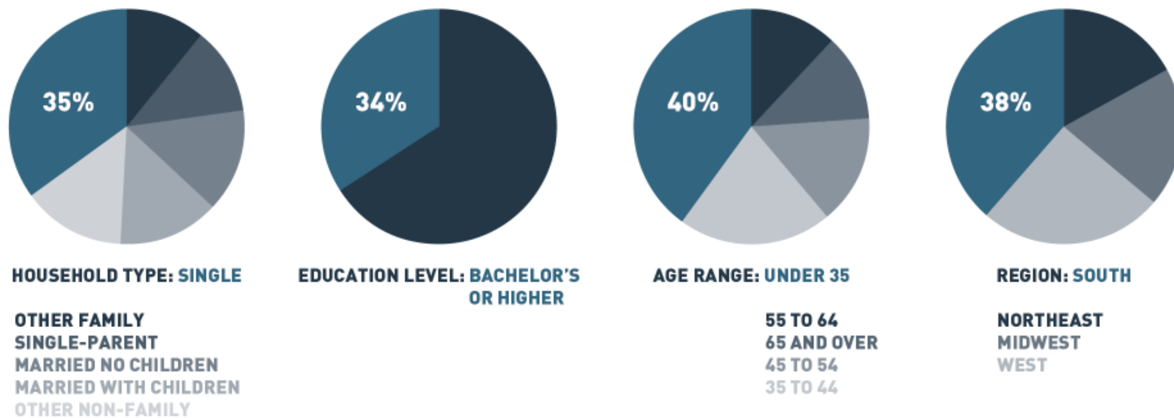
EXECUTIVE SUMMARY

Middle-income rental housing is fundamentally the best investment opportunity in multifamily today. A combination of favorable demographics and the ever-increasing need for affordable homes is improving demand fundamentals. At the same time the luxury supply wave has crested, which will create a window of opportunity for investment in this subsector in the coming years. In this paper, we will define the subsector, its fundamentals, benefits and risks, and show investors how an allocation to middle-income rental housing can help generate higher and more stable returns from their multifamily portfolio, while also addressing a critical societal need to preserve affordable housing.

DEFINING THE SUBSECTOR

Middle-income rental housing (often referred to as "workforce" housing) is rental housing inventory priced such that households making 60% to 120% of area median income (AMI) as defined by the United States Department of Housing and Urban Development (HUD) can pay rent without cost burden. A household is considered cost-burdened if total annual rent payments are more than 30% of annual household income.

While middle-income households have been characterized as "workforce," the profile of a middle-income household is broader than the oft-envisioned police officers and nurses and it is much more productive to examine this category of renters by income rather than occupation. According to an analysis of Census data by the Joint Center for Housing Studies (JCHS) of Harvard University, middle-income renter households have a median income of $63,000 per year and more than a third are single-person households. These renters also have moderate educational attainment, with 34% of middle-income households having a bachelor's degree or higher, just below the national average of 37%. A whopping 40% of middle-income households are under age 35 and these renter households are most prevalent in the Southern region of the United States.



SOURCE: JOINT CENTER FOR HOUSING STUDIES HARVARD UNIVERSITY, KETTLER MARKET RESEARCH

While low-income renters continue to experience the most severe cost burdens, middle-income renters are gaining attention as the cohort whose cost burdens are rising the fastest.[1] This rise in cost burden can be explained by a combination of the increase in demand for middle-income rental units and a lack of middle-income rental housing supply.

[1] Harvard University Joint Center for Housing Studies, "Subsidizing the Middle – Policies, Tradeoffs, and Costs of Addressing Middle-Income Affordability Challenges."

RISING DEMAND

A report released by JCHS earlier this year concludes that while Millennials remain the largest renter demographic group in the United States, they are rapidly ceding ground to Generation Z, the oldest of whom are now 29. The report states that "the number of Gen Z-headed renter households more than doubled to 7.9 million, accounting for all net growth in renter households" between 2019 and 2022.[2] The Millennial cohort is more likely than the Gen Z cohort to rent in less affordable Class A apartments and is well into their prime homebuying years. Gen Z renters are more likely to be categorized as middle-income, as they generally have moderate education attainment and lower incomes compared to the older Millennials.

Recent rental demand reflects this generational shift. Absorption of rental units has been volatile since 2020 but resumed a more typical seasonal pattern in 2024 and has been stronger than expected after turning negative last year. RealPage reports a national absorption total of 488,733 units from the third quarter of 2023 to the third quarter of 2024, which is two and a half times the long-term average of just under 200,000 units per year.[3] RealPage expects annual absorption to peak in mid-2025 at about the same level we observed at the beginning of 2022 - a record high.

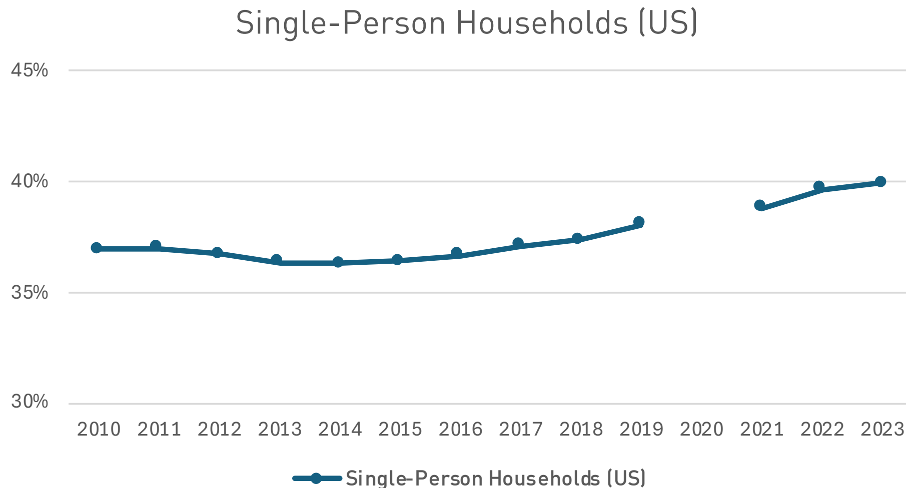
SOURCE: REALPAGE, KETTLER MARKET RESEARCH

Overall rental demand is getting an assist from several trends including an increase in single renters, a decrease in homeownership rates and record low affordability in the for-sale sector due to a combination of high home prices, low supply and interest rate lock-in effects. Census data show that there has been a rise in single-person households, with 40% of rental households in 2023 having just one occupant.[4] This represents an increase of more than three percentage points from the pre-pandemic average.

[2] Harvard University Joint Center for Housing Studies, "America's Rental Housing 2024."

[3] Note: RealPage tracks communities that are typically more institutional in nature – those located in defined metro areas that are often larger than 50 units. The Census starts and deliveries data include properties with five or more units in defined metro areas as well as rural locations.

[4] U.S. Census Bureau, American Community Survey, 2023.



SOURCE: U.S.CENSUS, MOODY'S ANALYTICS, KETTLER MARKET RESEARCH

Note: Data for 2020 is not available due to the pandemic.

The Federal Reserve has begun cutting its overnight rates, but 30-year mortgage interest rates are tied more closely to the 10-year Treasury, which has remained stubbornly high, reducing home purchase affordability. The historically low interest rates of the pandemic years have created a situation in which many owners are "locked in," refusing to sell and relinquish incredibly low fixed interest rates, creating a shortage of available homes. This lock-in effect combined with chronic underproduction of housing since 2008 has resulted in an increase in home prices.

The affordability gap between renting and owning is now astonishingly high with Moody's Analytics estimating the cost of a monthly home mortgage payment that is $766 more than a monthly rent payment as of the beginning of 2024. Many households that would have purchased a home are now priced out and will continue renting, leading to sustained demand for rental housing.

Another pressing issue for middle-income households of late has been inflation. High inflation has eaten away at healthy wage increases across the spectrum but households in the middle have seen slightly less wage growth than those at the the low end of the income distribution and have continued to experience price increases for essentials. As a result, growth in real earnings from 2019 to 2023 has been lower for middle-income workers than for low-income workers.[5]

In recent consumer sentiment surveys from the University of Michigan, middle-income households reported greater deterioration in their personal financial conditions over the past year relative to high-income households and their consumer sentiment remains low. The top reason cited for this malaise was higher prices.[6]

While it is difficult to know for sure what policies will be implemented by a second Trump administration, many economists project continued elevated inflation levels. It is clear from the the polling and results of the most recent presidential election that households are still experiencing distress from the cumulative effects of the inflationary environment of the past few years. Elevated inflation has a tempering effect on real wages and households are likely to see affordability worsen if prices continue to climb.

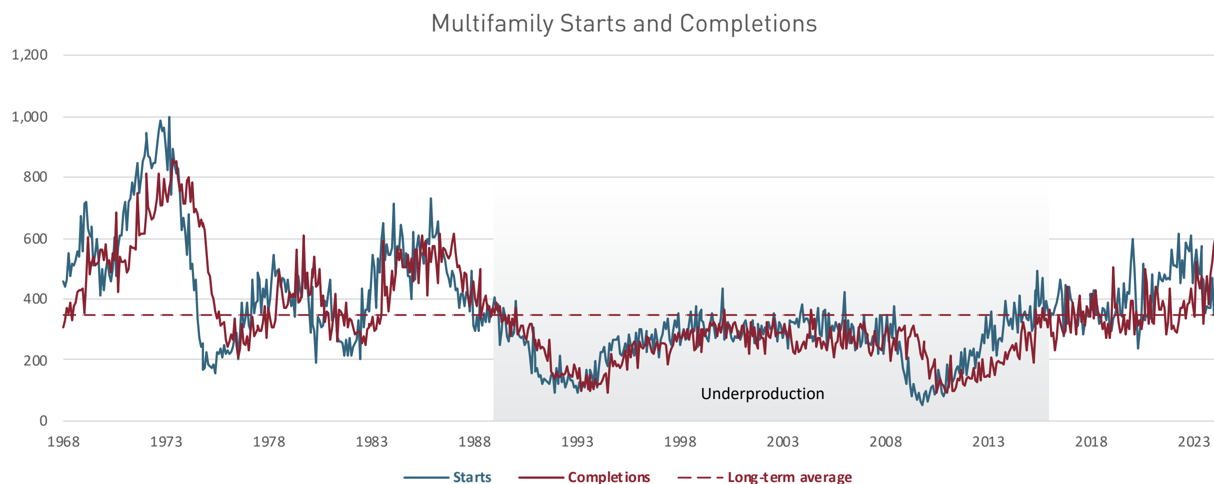
[5] U.S. Department of the Treasury, "The Purchasing Power of American Households."
[6] University of Michigan, "Surveys of Consumers," August, 2024.

LACK OF SUPPLY

It is widely accepted that there is a housing shortage in the U.S. with estimates of the shortfall ranging from 1.5 million homes per the National Association of Home Builders to more than 5 million homes according to the National Association of Realtors. Despite recent record increases in rental supply, there is still excess demand for rental housing in many markets, particularly in the middle-income band of affordability. Some markets have added enough supply that they are experiencing temporary gains in affordability due to rent decreases over the past year. However, rental construction starts slowed dramatically as the Federal Reserve raised interest rates and lending conditions tightened, limiting opportunity for new development. As completions wane, affordability will continue to worsen in the face of increasing demand.

Underproduction of multifamily housing decades ago is creating an affordability problem today. Completions of housing units in buildings with five or more units dropped in the 1990s and then remained relatively low until the mid 2010s.

Multifamily housing has been underproduced for decades for a variety of reasons, with very low production periods in the early 1990s and in the years following the Global Financial Crisis (GFC) from 2009 to 2015.



SOURCE: U.S.CENSUS, HUD, ST. LOUIS FEDERAL RESERVE, KETTLER MARKET RESEARCH

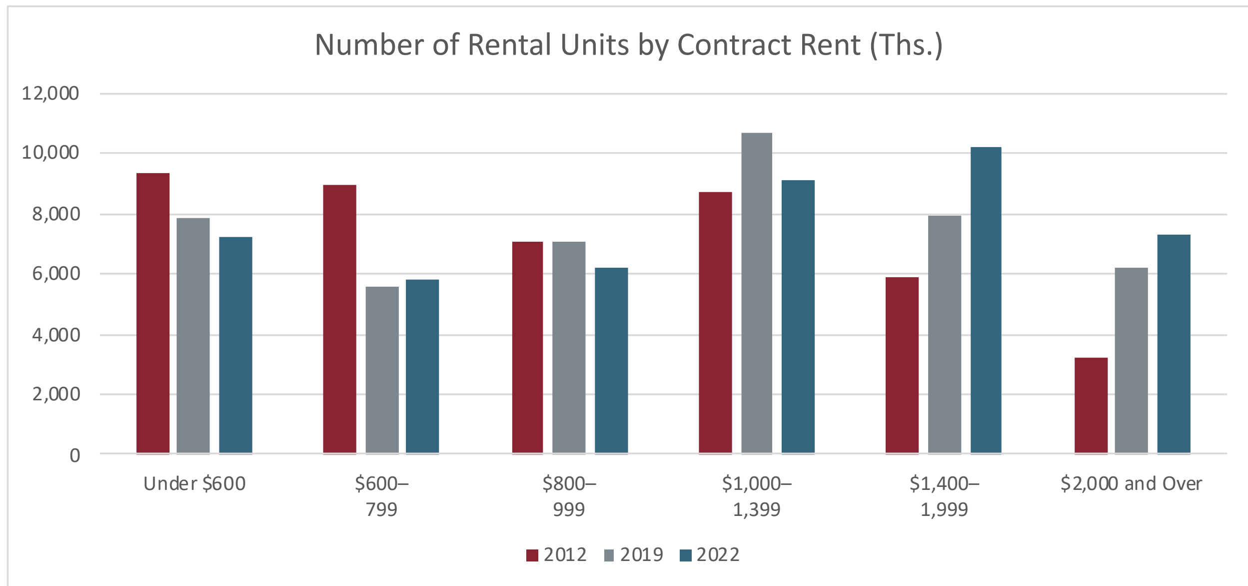
From the 1980s until the GFC, fiscal impact zoning took hold in most suburban areas including close-in suburbs and exurbs. The discretionary approval process for new construction increased costs and suppressed multifamily housing supply due to a bias toward large-lot, single family homes.[7]

In addition to regulatory hurdles to rental construction prior to 2008, the GFC led to a housing shortage on both the multifamily and single-family sides as financing for any new construction was difficult to obtain while the financial system recovered from the crisis.

[7] Housing Affordability Institute, "History of Exclusion in America's Housing Policies."

The multifamily housing that was produced in the 1990s and 2000s is the naturally occurring affordable housing stock of today that serves middle-income households. Unfortunately, too little multifamily housing was built then, resulting in a shortage of affordable stock for low- and middle-income renters now.

It has only been since 2015 that multifamily production has surpassed the long-term average of just under 350,000 units annually, though these newer units may be out of reach for middle-income households in terms of affordability. In fact, rental stock composition has shifted to higher-priced units due to this construction drift to later years.



SOURCE: JCHS TABULATIONS OF CENSUS BUREAU ACS DATA, KETTLER MARKET RESEARCH

Note: Rents are inflated to 2022 dollars using the CPI-U for All Items Less Shelter.
Units that are occupied but do not receive payment are excluded. Contract rents exclude utility costs.

Supply will continue to be a challenge for middle- and low-income households, presenting an opportunity and a critical need for investment.

THE BENEFITS OF MIDDLE-INCOME RENTAL HOUSING

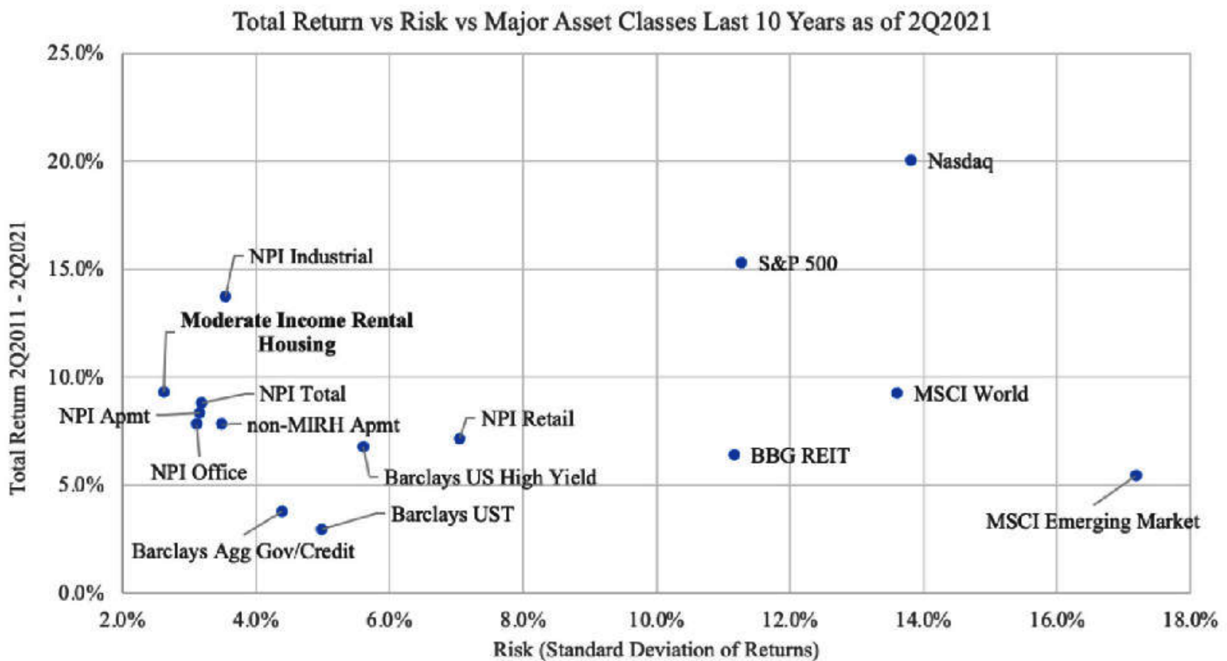
Fundamental Tailwinds: Investment in middle-income rental housing is underpinned by strong fundamentals. The factors driving demand in this sector including increased household formation due to the rise of Gen Z and expansion of single-person households, decreasing homeownership and a stabilization or decrease in real wages are likely to continue or intensify in the coming years. The middle-income rental housing segment has been persistently undersupplied and should remain so for years to come.

Higher and more stable returns: Importantly, studies have shown middle-income rental housing offers higher returns with lower volatility than less affordable, high-income targeted rental housing and better outcomes when compared with other property types and major asset classes.

In a study analyzing the performance of middle-income rental housing for a ten-year period from 2011 to 2021, Mark Roberts and Jake Wegmann used aggregated data from the NCREIF Property Index (NPI) to show that "moderate-income rental housing (MIRH) compares favorably in terms of

its return and has a lower variation in total returns from year to year (risk) since 2011 as compared to other common asset classes."[8]

Roberts and Wegmann found that the average total rate of return for MIRH of 9.35% over the decade analyzed exceeded the returns for all classes of apartments (8.37%) and higher-income rental housing (classified as "above-MIRH" at 7.86%). Importantly, returns for MIRH were found to have a lower standard deviation of returns (2.6%) and therefore, were deemed more stable than other major asset classes analyzed.



SOURCE: ROBERTS AND WEGMANN

MIRH returns were also found to have a reduced correlation to other non-real estate asset classes, indicating an opportunity for portfolio diversification.

More recently, a similar analysis by PREA's Greg MacKinnon looking at NCREIF data over a longer period from 1Q 2008 to 1Q 2024 bolstered Roberts and Wegmann's finding that the most affordable multifamily property types had higher returns per quarter on average with lower volatility.[9] The results of MacKinnon's analysis showed that returns were highest and volatility lowest in the most affordable apartment communities, followed by mid-market communities and finally, least affordable communities. Returns for the most affordable and mid-market communities were higher than the least affordable segment when broken down into both income return and appreciation return.

[8] Roberts, Mark G. and Jake Wegmann, "Moderate-Income Rental Housing: Assessing its Viability as an Asset Class for Real Estate Investment with Environmental, Social, and Governance (ESG) Criteria."
[9] Greg MacKinnon, "Can Investors Afford to Ignore Affordability? The Investment Characteristics of Affordable Housing."

	Most Affordable	Mid-Market	Least Affordable
Average Return/ Quarter	1.64%	1.42%	1.06%
Volatility of Quarterly Returns	2.78%	2.87%	2.89%
Compound Average Annual Return, 1Q2008 to 1Q2024	6.54%	5.62%	4.15%

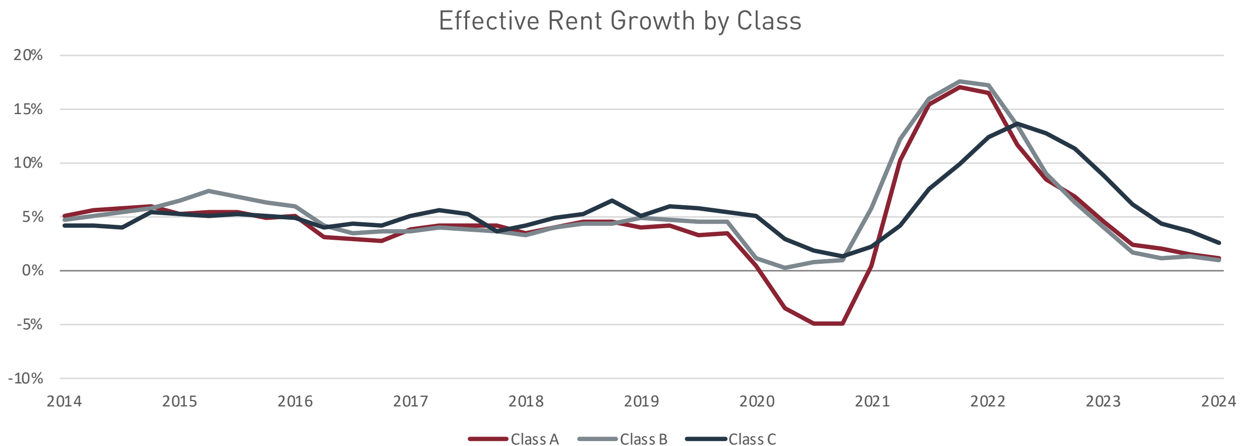
SOURCE: PREA RESEARCH BASED ON NCREIF DATA

The Roberts and Wegmann and MacKinnon research has found that middle-income rental housing has consistently outperformed less affordable communities over time with lower volatility. These findings are not surprising as the combined outperformance and stability in middle-income rental housing seems to have three main drivers.

First, the persistent shortage of middle-income housing has led to "sticky" inelastic demand. Renter need is already great and likely to grow with continued supply shortages in the coming years and outperformance is the likely result.

Volatility is muted in middle-income rental housing compared to less affordable Class A stock because oversupply of newer units impacts the Class A pricing equation more directly, putting more price pressure on the luxury side of the spectrum when demand is constant. Supply impacts take time to filter to the more affordable communities and the supply necessary to meaningfully impact middle-income housing is substantial and unlikely to materialize.

Finally, middle-income rental housing is less impacted by economic downturns and tends to be even more desirable when the economy is slowing or in recession.

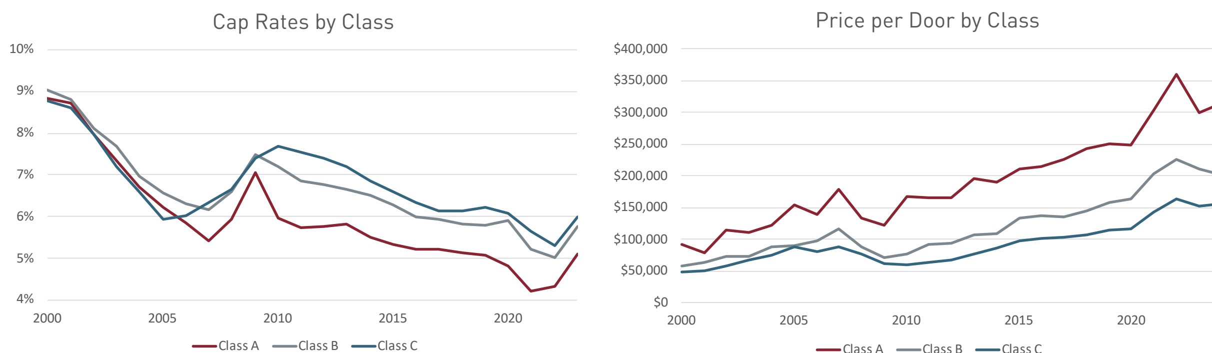


SOURCE: REALPAGE, KETTLER MARKET RESEARCH

Positive Social and Environmental Impacts: Strategies dedicated to preserving and improving middle-income rental housing offer investors the opportunity to do well by doing good, providing attainable housing and services to households in need, while also often improving the carbon footprint of older properties through targeted capital improvements.

Increasing Incentives for Investment: As middle-income households increasingly struggle with affordability, there are more incentives available to make investment in this subsector easier. Middle-income housing investors can increasingly utilize agency-backed financing options, designed to create and preserve affordable housing to enhance returns on equity and encourage additional investment. In addition, states and jurisdictions across the country, including Virginia, Colorado and Michigan have recently adopted or are considering policies and programs to encourage the development of units targeted to middle-income renters.

Appreciation Opportunity: In addition to higher income returns and lower volatility, investors in middle-income rental housing also have the opportunity to acquire assets at an optimal basis and achieve favorable appreciation. We observe a per unit basis discount for Class B and C properties of 44% compared to Class A properties in metro markets nationally from 2000 to 2023, along with a cap rate spread of 80 bps.[10] As the need for middle-income housing grows and more capital discovers the subsector, there is an opportunity for that cap rate spread to compress.



SOURCE: COSTAR, KETTLER MARKET RESEARCH

[10] CoStar transaction data analyzed by KETTLER Market Research

FACTORS TO CONSIDER

The higher and more stable return profile offered by middle-income rental housing comes with added risks for investors to consider and manage.

Higher Capital Expenditures: Apartment stock is older than it has ever been, and many properties are not just inadequate to house today's renters but may be unsafe.[11] While capital expenditures are expected to be higher in middle-income rental communities, it is important to avoid unexpected overhauls that do not contribute to the success of an investment. Proper due diligence and healthy budgets to maintain communities are essential to investment performance. Roberts and Wegmann note that MIRH assets have lower occupancy rates and higher capital expenditure requirements than their non-MIRH counterparts. They conclude that these factors are more than offset by higher income and total returns as shown in the table below.[12]

10YRS from 2Q 2011 – 2Q2021	Total Return	Standard Deviation	Yield	Annual Cap Ex as a % of Market Value
Moderate Income Rental Housing NPI	9.40%	2.60%	4.80%	1.50%
Non Moderate Income Rental Housing NPI	7.90%	3.50%	4.40%	0.90%
Spread (+/-)	1.50%	0.90%	0.40%	0.6%

SOURCE: ROBERTS AND WEGMANN, KETTLER MARKET RESEARCH

Regulatory Risk: The political/regulatory environment must be considered when investing in middle-income rental housing. Rent regulation is increasingly part of the narrative when solutions to the housing affordability crisis are being sought. The impact of rent regulation on housing affordability is hotly debated and we do not intend to wade into that issue here. What perhaps is less debatable is that the introduction of new regulations or changes to existing rent regulations can have a significant impact on investment outcomes.

For instance, the New York State Housing Stability and Tenant Protection Act of 2019 curtailed allowable rent increases for rent-stabilized apartments to 2% for major capital improvements down from 6% and 15% in some instances. The legislation also eliminated several pathways for rent-stabilized apartments to become market rate. Business plans and values predicated on allowable rent increases before this change were clearly negatively impacted. It is important for investors in middle-income rental housing to consider and monitor the potential for changes in rent regulation throughout the life of an investment and to plan accordingly.

Operating Risk: Operational risk is one of the most important factors to consider when investing in middle-income rental housing. Property managers with experience monitoring and maintaining affordability standards are essential for compliance with financing and ESG requirements. In addition, experienced property managers will offer greater efficiency through centralized operations, economies of scale and by providing services that enhance the resident experience.

[11] Harvard University Joint Center for Housing Studies, "America's Rental Housing 2024."
[12] Roberts, Mark G. and Jake Wegmann, "Moderate-Income Rental Housing: Assessing its Viability as an Asset Class for Real Estate Investment with Environmental, Social, and Governance (ESG) Criteria."

Operating expenses for multifamily properties have increased substantially since 2022, driven primarily by higher insurance, utilities and staffing costs. According to research from operating platform Yardi, average operating expenses rose 8.4% from 2022 to 2023 and 6.5% from 2023 to 2024 due to these expense categories.[13] Staffing costs are stabilizing as the labor market normalizes, but potential outsized growth in utilities and insurance costs is worrisome. Although increased operating expenses affect the entire multifamily sector, older properties may be disproportionately impacted.

CONCLUSION

Investors looking to improve the efficiency of their real estate portfolios should consider a healthy allocation to middle-income rental housing. The combination of supply and demand imbalance for middle-income units and the higher, more stable return profile of this subsector, makes for a compelling investment opportunity. Incremental capital expenditure requirements, regulatory and operating risks must be considered. However, those risks can be effectively mitigated and are compensated for by middle-income rental housing's higher income and total return potential. Importantly, a "move to the middle" affords investors the opportunity to do well by doing good, earning superior risk-adjusted returns, while addressing the pressing societal need for more affordable housing.

[13] Yardi Matrix Expert data.

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KETTLER is a vertically integrated, multifamily focused investment firm, an award-winning real estate and land developer, and property management company. The firm has over 47 years of providing superior capabilities across the investment lifecycle; acquisition, zoning/entitlement, predevelopment, leasing, operations, asset management and disposition.

Founded in 1977, the company has acquired nearly 12,000 units, developed over 25,000 multifamily units, 8 million square feet of commercial space, more than 78,000 homes in 25 master-planned communities, and many of the D.C. region's premier mixed-use communities. KETTLER is a top U.S. multifamily investor recognized for placemaking, complex mixed-use projects, workforce housing, the quality of our assets, a connection to our communities and delivering on behalf of our partners. Headquartered in McLean, Va., the company manages approximately 20,000 apartments in the Northeast, Mid-Atlantic, and Southeast regions. For more information please visit www.KETTLER.com.

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